No. 05-1590

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

JOHN MOORES, *et al.*,
Petitioners,

v.

ROBERT C. FRIESE,
Respondent.

On Petition for a Writ of Certiorari to the California Court of Appeal, Fourth Appellate District, Division One

REPLY TO BRIEF IN OPPOSITION

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Respondent spends little time on the merits of the Petition's constitutional arguments, *see* Opp. 20-23, resting principally instead on the arguments that this Court lacks jurisdiction to review them and that they were not presented to the state courts below. Both assertions are incorrect.

First, this Court has jurisdiction to review the decision below. Under *Cox Broadcasting Corp. v. Cohn*, 420 U.S. 469 (1975), the Court of Appeal's decision should be treated as a final judgment for purposes of determining this Court's jurisdiction under 28 U.S.C. § 1257(a). The California Court of Appeal, with review denied by the California Supreme Court, has determined with finality that Section 25502.5 applies to foreign corporations, and a decision in Petitioners' favor would determine the outcome in this case. Second, Petitioners pressed their constitutional arguments in the courts below, arguing at every level that application of California Corporations Code Section 25502.5 to foreign corporations would violate the Commerce and Due Process Clauses of the federal Constitution. Petitioners should not be penalized for the state courts' failure to address their federal constitutional claims.

Respondent's arguments on the merits are no more availing. The Court of Appeal's decision creates a clear tension between California and Delaware law regarding federal constitutional limits on one State's ability to "deputize" an out-of-state corporation as a "private attorney general" to serve that State's own idiosyncratic policy interests. The amicus brief filed in support of Petitioners vividly depicts the uncertainty and confusion the decision below has created for the nation's corporations and their officers and directors doing business across state lines. *See* Brief of Amici Curiae Technology Network, *et al.* in Support of Petitioners, filed August 14, 2006. Review by this Court is warranted.

I. THE COURT HAS JURISDICTION UNDER 28 U.S.C. § 1257

The California courts have ruled definitively that California Corporations Code Section 25502.5 may be extended across state lines to govern the internal affairs of Delaware and other foreign corporations. Contrary to Respondent's suggestion that review should await the final word of a final state court, Opp. 14-16, this Court need not await the completion of additional proceedings anticipated in the lower courts. This Court "has recurringly encountered situations in which the highest court of a State has finally determined the federal issue present in a particular case, but in which there are further proceedings in the lower state courts to come." *Cox Broadcasting Corp. v. Cohn*, 420 U.S. 469, 477 (1975). As in many of those situations, the Court should treat the judgment below as a final judgment for purposes of 28 U.S.C. § 1257.

Cox Broadcasting expressly contemplated, as its fourth category of such situations, that a state-court judgment will be treated as final

> where the federal issue has been finally decided in the state courts with further proceedings pending in which the party seeking review . . . might prevail on the merits on nonfederal grounds, thus rendering unnecessary review of the federal issue by this Court, and *where reversal of the state court on the federal issue would be preclusive of any further litigation on the relevant cause of action* rather than merely controlling the nature and character of, or determining the admissibility of evidence in, the state proceedings still to come. . . . [I]f a refusal immediately to review the state court decision might seriously erode federal policy, the Court has entertained and decided the federal issue . . . .

Id. at 482-83 (emphasis added).

This case aptly fits that category. California's state courts have finally and unconstitutionally decided to apply Section 25502.5 to foreign corporations. The published California Court of Appeal opinion holding that Section 25502.5 governs claims by Delaware and other foreign corporations against their own directors and officers is now the definitive interpretation of Section 25502.5. The California Supreme Court summarily denied Petitioners' petition for review. There is no other California state-court decision interpreting Section 25502.5.

Consistent with the fourth *Cox Broadcasting* category, a reversal of the Court of Appeal's decision on constitutional grounds would preclude any further litigation on those causes of action. Indeed, reversal of the Court of Appeal's decision on constitutional grounds might well preclude years of complex litigation and trial altogether. Respondent concedes that its alternative claim challenging Petitioners' stock trades under Delaware law requires proof of scienter, *see* Pet. App. 30a, and a federal district court has already concluded that claims by Respondent's beneficiaries based on the same set of facts failed to allege Petitioners' scienter as a matter of law. *See In re Peregine Systems, Inc., Securities Litigation*, No. 02 CV 870-BEN (RBB) (S.D. Cal. March 30, 2005).[1]

Treatment of the Court of Appeal's decision as final thus would serve this Court's "pragmatic approach" to the finality

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[1] Respondent repeatedly invokes the misleading characterization that "this is an insider trading case." *See, e.g.*, Opp. 11. Respondent neglects to mention, however, that no court and no government official has ever credited Respondent's claims. To the contrary, when Respondent's beneficiaries asserted federal securities fraud claims against Petitioners in a class-action complaint, including the very same allegations about stock sales, a federal district court dismissed those claims on the pleadings. *See In re Peregrine, supra.* The district court noted specifically that that there was nothing suspicious about the amount or timing of any of Petitioners' stock sales. *See id.* at 100-08.

requirement, and the policy of preventing economic waste and delayed justice that underlies it. *See Shaffer v. Heitner*, 433 U.S. 186, 195 n.12 (1977) ("'[Appellants] may prevail at trial on nonfederal grounds, it is true, but if the (Delaware) court erroneously upheld the statute, there should be no trial at all.'"); *Mercantile Nat'l Bank v. Langdeau*, 371 U.S. 555, 558 (1963) ("[I]t serves the policy underlying the requirement of finality in 28 U.S.C. § 1257 to determine now in which state court appellants may be tried rather than to subject them, and appellee, to long and complex litigation which may all be for naught if consideration of the preliminary question of venue is postponed until the conclusion of the proceedings."); *Cox Broadcasting*, 420 U.S. at 477-78 ("[I]mmediate rather than delayed review would be the best way to avoid 'the mischief of economic waste and of delayed justice.'") (quoting *Radio Station WOW, Inc. v. Johnson*, 326 U.S. 120, 124 (1945)).

Further, review of the Court of Appeal's decision is appropriate because "refusal immediately to review the state court decision might seriously erode federal policy." *Cox Broadcasting*, 420 U.S. at 483. Longstanding federal policy with roots in the Commerce and Due Process Clauses dictates that only the state of incorporation has the power to regulate a corporation's internal affairs and the corporation's relations with its directors and officers. California's recent attempts to erode this federal policy for the sake of its own policies has led to serious concern in the national business community that underscores the need for this Court's review.[2] *See* Brief of Amici Curiae, *supra*, at 15-19; *Directors' and Officers'*

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[2] This Petition is therefore readily distinguishable from the one considered in *Flynt v. Ohio*, 451 U.S. 619 (1981), cited by Respondent. *See* Opp. 17. In *Flynt*, resolution of the federal issue affected only the petitioners, who claimed that they had been subjected to selective and discriminatory prosecution. *Id.* at 620. The Court specifically held that there was no broader issue presented. *Id.* at 622.

Liability: Conflicting Regulation on Internal Affairs, N.Y. LAW JOURNAL, August 10, 2006, at 5 (noting that, in light of the Court of Appeal's decision, "[t]here is now an irreconcilable conflict between the courts of the nation's most populous state and those of the preeminent state of incorporation concerning the extent of California's authority to regulate the internal affairs of Delaware corporations—an issue of great legal and practical significance to the business community—and it is ripe for Supreme Court resolution").

The decision below presents cleanly the federal constitutional questions whether the Commerce and Due Process Clauses permit one State to regulate the internal affairs of another State's corporation. These issues will persist, and are independent of any state-law issues remaining to be resolved.

II. PETITIONERS PROPERLY PRESENTED THEIR FEDERAL CONSTITUTIONAL ARGUMENTS IN THE STATE COURTS BELOW

Contrary to Respondent's assertions, Opp. 18-20, the failure of the California Court of Appeal to address the federal constitutional issues that Petitioner raised in three separate state-court filings below does not preclude this Court's review.

First, Petitioners have already shown that they properly presented their constitutional arguments in the state courts. *See* Pet. 8-10. Contrary to Respondent's suggestion, *see* Opp. 18, Petitioners were not required to present federal constitutional issues in their notice of demurrers. Indeed, they could not do so under California law. *See* Cal. Civ. Proc. Code § 430.10 (specifying enumerated grounds for demurrer, including the only applicable ground, raised by Petitioners, that "[t]he pleading does not state facts sufficient to constitute a cause of action"). In their brief in support of their demurrers, Petitioners specifically noted that allowing a Delaware corporation to pursue claims under California law against its own officers and

directors for misuse of nonpublic corporate information would violate the Commerce and Due Process Clauses of the United States Constitution. Pet. App. 34a-35a (citing *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), and noting "*CTS Corp.* makes clear 'that the commerce clause mandates that a state apply the internal affairs doctrine'").

Second, Respondent ignores the fact that this case arises from the Superior Court's order ruling in Petitioners' *favor*—a result that required the state appellate courts, before reversing, to consider all grounds, including federal constitutional grounds, that could have supported the trial court's ruling. The trial court sustained demurrers to the first five causes of action "on the basis that Delaware law governs the relationship between Peregrine and its directors and/or officers." Pet. App. 29a. Although the Superior Court did not mention Petitioners' constitutional arguments in its brief order finding that Delaware law controlled, it was not required to do so. *See* Cal. Civ. Proc. Code § 472d. Indeed, because the Superior Court had concluded that Delaware law governed pursuant to California Corporations Code Section 2116 and the internal affairs doctrine, resolution of Petitioners' constitutional arguments was unnecessary. *See Mautner v. Peralta*, 215 Cal. App. 3d 796, 804 (1989).

Before any reversal of the trial court's ruling, the Court of Appeal was required to consider Petitioners' fully briefed constitutional arguments as alternative grounds supporting the trial court's order. Contrary to Respondent's statements, in reviewing the Superior Court's decision sustaining Petitioners' demurrers, the Court of Appeal was required under California law to look beyond the specific reasoning provided by the Superior Court. *See Weinstock v. Eissler*, 224 Cal. App. 2d 212, 225 (1964) ("Nowhere does [Section 472d] provide, as plaintiff would have it, that the order must be tested only according to the reasons given by the trial court. . . . [I]t is the validity of the court's *action*, and not of

the *reason* for its action which is reviewable." (emphasis in original)); *Mautner*, 215 Cal. App. 3d at 803 ("On review, we test the validity of the court's actions, not the reasons for its actions.").

Thus, as a matter of law, the Court of Appeal was required to consider any and all grounds supporting the demurrer—not just the ground relied upon by the trial court. *See Irwin v. City of Manhattan Beach*, 65 Cal. 2d 13, 20 (1966) ("If a complaint is insufficient on any ground properly specified in a demurrer, an order sustaining the demurrer must be upheld even though the particular ground upon which the court sustained it may be untenable."); *Gonzales v. State*, 68 Cal. App. 3d 621, 627 (1977) ("[S]ection 472d . . . has been interpreted . . . to require affirmance of a trial court's rulings on demurrers if any of the grounds raised by the defendant require the sustaining of the demurrer, whether or not the court specifies all the grounds."). Under California law, the Court of Appeal could not reverse the trial court's ruling without considering and addressing Petitioners' fully briefed arguments that any reversal would violate the federal Constitution. The Court of Appeal's failure to address the constitutional implications of its own ruling does not insulate those constitutional issues from this Court's review.[3]

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[3] *See, e.g., Supreme Council of the Royal Arcanum v. Green*, 237 U.S. 531, 537-41 (1915) (reviewing the application of New York law to a Massachusetts corporation as a violation of the Full Faith and Credit Clause even though the Clause was invoked only in a single paragraph of the answer and no New York state court ever discussed the Clause).

Respondent's reliance on *Street v. New York*, 394 U.S. 576 (1969), is unavailing, for in that case the Court concluded it had jurisdiction to review a federal constitutional issue that had been briefly raised at the trial court level, as here, even though the issue had not been addressed by the state appellate court. *Id.* at 581-84. Respondent's remaining authority is readily distinguishable. *Luri v. Greenwald*, 107 Cal. App. 4th 1119 (2003), did not address review of a demurrer ruling at all. *Id.* at 1124-25. And, unlike Petitioners, the appellant in *Duignan v. United States*, 274 U.S. 195

Petitioners' specific statement of the constitutional issues in the Superior Court briefing and full briefing of those issues in three separate filings in the appellate courts was more than sufficient for proper presentation to the state courts. The appellate court's federal constitutional error warrants this Court's review.

III. THE CALIFORNIA STATUTE VIOLATES THE COMMERCE AND DUE PROCESS CLAUSES

Contrary to Respondent's suggestion, Section 25502.5 is not a run-of-the-mill "insider trading" statute that protects California investors in California securities markets. It purports to govern claims by any foreign corporation, regardless whether it does any business at all in California, and affords such corporation treble damage claims against its own directors and officers if they are merely physically present in California when they made any decision to buy or sell stock, even if the actual purchase or sale occurred outside of California on a national exchange. *See* Cal. Corp. Code §§ 25502.5(a), 25008. Unlike California investors or officials, a Delaware corporation alleges not any injury to California markets, but rather a breach of official duty to the corporation, when it charges its own director with misuse of nonpublic information in connection with sales of the corporation's stock. Thus the issue in this case is quite narrow; it focuses solely on whether Section 25502.5, not Section 25402, violates the federal Commerce and Due Process Clauses as invoked by an out-of-state corporation.

Respondent ignores by lack of argument the three distinct ways in which Section 25502.5 violates the Commerce

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(1927), had abandoned any constitutional issues at the appellate court level. *Id.* at 200. Finally, the Court in *Ackermann v. United States*, 340 U.S. 193 (1950), was not even addressing the issue of proper presentation. *Id.* at 195, 197 (addressing question whether failure to file a timely appeal was excused under Rule 60).

Clause: reaching beyond California's borders to regulate claims by a Delaware corporation against its own directors and officers; directly regulating interstate purchases and sales of securities; and indirectly burdening interstate commerce with the risk of inconsistent regulation of directors' and officers' duties and liabilities to the corporations they serve. *See* Pet. 14-20; *see also* N.Y. LAW JOURNAL, *supra*, at 5.

Respondent instead seeks to avoid the force of these well-established principles by asserting that no intrusion on internal affairs is presented when directors are alleged to have *violated* their official duties. *See, e.g.*, Opp. 10, 20. This assertion is incorrect. *See* Restatement (Second) Conflict of Laws § 309 comment a ("Liability will typically be imposed upon directors under the [internal affairs doctrine] for such matters as the fraudulent or negligent mismanagement of the corporation's affairs, the unlawful declaration of dividends, the making of false returns, the unlawful acquisition of treasury stock and unlawfully profiting at the corporation's expense."). Misuse of inside information obtained in an official capacity is no less a breach of official duty than is "fraudulent or negligent mismanagement" or "unlawfully profiting at the corporation's expense." Contrary to Respondent's assertion, the claims here are squarely governed by the internal affairs doctrine.

Elsewhere, Respondent makes concessions that only highlight the Commerce Clause infirmity of applying Section 25502.5 to an out-of-state corporation. Respondent admits that California seeks to "deputize[]" corporations organized under the laws of other states as "private attorneys general" "to assist in deterring insider trading." Opp. 21. While California may deputize investors in its markets in such a role in a perceived effort to further California policies, it may not deputize an out-of-state corporation without intruding unconstitutionally into that corporation's internal affairs.

Respondent also concedes that a sister State has exclusive jurisdiction over such classic internal affairs of an out-of-state corporation as "the holding of directors' and shareholders' meetings." Opp. 9. Respondent conspicuously fails to mention, however, that Section 25502.5(c) intrudes squarely into that domain, purporting to set forth demand and quorum requirements for board meetings involving insider trading claims against the corporation's directors. This provision thus falls squarely within Respondent's own definition of a corporation's internal affairs, and nothing in the decision below suggests that this provision is severable from the rest of Section 25502.5.

Finally, in addressing Petitioners' Due Process challenge, Respondent ignores the fact that no California decision had previously allowed a foreign corporation to invoke Section 25502.5 at all, much less for so vague a reason as the "interests of justice." Petitioners were thus deprived of fair warning. Having consistently represented to Petitioners that their liability to the corporation would be governed by Delaware law, Peregrine should not now be permitted a bait and switch to California law with its unique treble damage remedy. For these reasons, this Court should review the decision below for inconsistency with the Due Process Clause.

Respectfully submitted,

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